Payday Lending:
Reforming the Debt Trap in California

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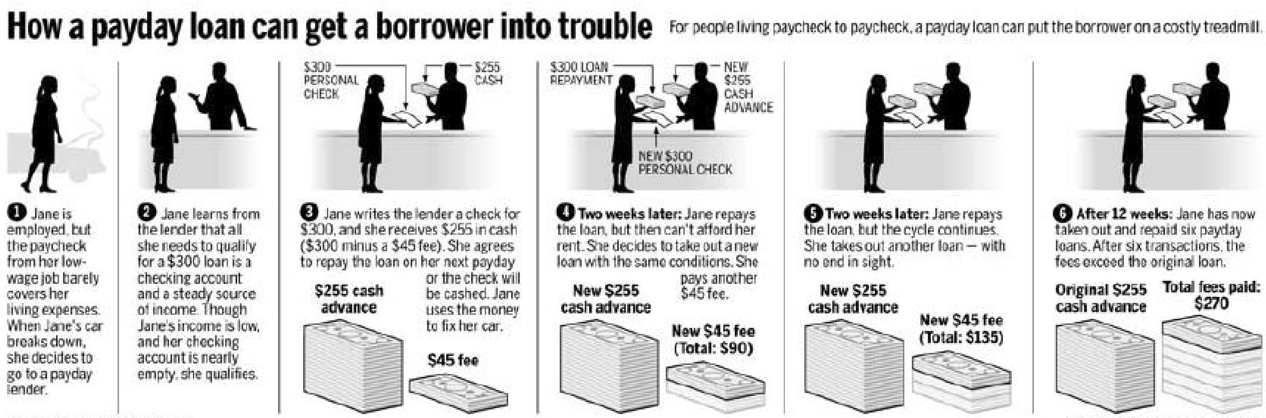
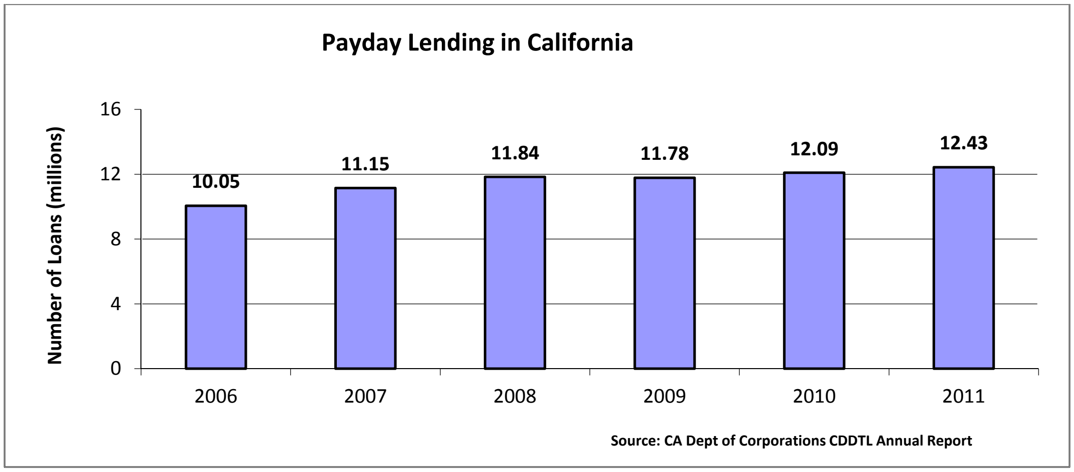
What is a Payday Loan? Payday loans are small, short-term loans that are marketed as a quick, easy way to tide borrowers over until the next payday. They work like this: a borrower writes a check to the payday lender for the loan amount plus interest, and either the borrower repays the loan directly or the lender can deposit the check on the borrower's next payday. In California, a consumer can borrow up to $255. For a $255 loan, the borrower writes a $300 check ($255 loan plus $45 interest) that will be due typically about 2 weeks later, amounting to an annual interest rate of 459%. Borrowers don't need much to qualify—proof of income (from work, Social Security or even unemployment insurance) and a checking account.

Payday Loans Create a Debt Trap. For California families living paycheck to paycheck, the high price of a payday loan and the fact that it must be paid off in one lump sum two short weeks later virtually ensures that cash-strapped borrowers will be unable to meet their basic expenses and pay off their loan with their next paycheck.[1] Consequently, too many Californians are forced to pay off one loan and immediately take out a new loan, repeating the cycle over and over. Although payday loans are marketed and publicly rationalized as a short-term loan for an occasional, unexpected expense, research shows – and payday lenders actually admit in private – that the business model is designed to keep borrowers coming back for more and more payday loans.[2]



After six payday loans (fewer than the California average), Jane pays $270 in fees to borrow $255.

<u>The Data Illustrate the Debt Trap.</u> The most recent annual data from the California Department of Corporations (DoC) show that in 2011, Californians took out more than 12.43 million payday loans.[3] The number of payday loans taken by Californians has been steadily growing since 2006, with the total 2011 volume nearly 25% higher than the 2006 volume.[4] CRL research shows that <u>three-quarters of payday volume is generated by churning</u>, i.e., by borrowers who, after repaying the loan, must re-borrow before their next pay period in order to make ends meet.[5]



The most recent raw numbers (12.43 million loans by 1.74 million borrowers) suggest that the average California borrower takes out slightly more than 7 loans per year, but these numbers do not account for payday borrowers who borrow from multiple stores or where different people from the same household take out payday loans.[6] A detailed 2007 report on payday by the DoC takes this into account and reveals an even greater pattern of repeat lending.

- *Most Borrowers Are Regular Users*: The average number of loans for the one million borrowers was 10, exceeding the national average of 9 per year.[7]
- *Most Loans Go to Borrowers Caught in a Debt Trap*: Nearly 450,000 borrowers had back-to-back spells of 6 loans or more, conservatively accounting for more than 50% of all loans.[8]
- *For Many Borrowers, There is No Way Out*: 57,147 borrowers had more than 19 consecutive transactions during 2006. These borrowers accounted for only 4% of borrowers, but a startling 25% of the 10 million loans taken out in 2006.[9]
- *Very Few Borrowers Take Just One Loan*: Less than 4% of loans went to one time borrowers.[10]

<u>Payday Loans Exacerbate Borrowers' Poor Economic Circumstances.</u> Economists studying payday lending have found that it leads to economic harms beyond the debt trap.

- *Defaults.* Although default rates on individual loans are very low, half of all payday borrowers end their cycle of repeat loans by default.[11]
- *Bankruptcy*. Borrowers who are <u>approved</u> for a payday loan, as opposed to those who are <u>denied</u> a payday loan, are almost 90% more likely to file for bankruptcy.[12]
- *Other Delinquencies.* Payday borrowers are more likely to become seriously delinquent on their credit cards than similarly-situated people who do not use payday loans.[13]

How Should Payday Loans Be Reformed?

Make Payday Loans Affordable: Impose a Non-Predatory APR Cap. The only proven way for state policymakers to protect their citizens from predatory small loans is to enforce a comprehensive small loan law with an interest rate cap at or around 36 percent. Sixteen states and the District of Columbia have reasonable rate caps on small loans. In 2006, Congress enacted a federal 36 percent rate cap for members of the military and their families. These caps can and should serve as a model to states that currently authorize payday lending in any form. In these states and in the District of Columbia, citizens in need of credit to help them through an unexpected expense still can access affordable alternatives without sinking into high-cost, long-term debt.

Keep Payday Loans for Short Term Emergencies, Not Long-Term Debt: Place an Annual Loan Limit on Payday Loans. The payday lending industry asserts that its product is intended for occasional, short-term use. Capping the number of loans that a borrower can receive each year would, therefore, be consistent with the industry's definition of responsible use.[14] The California Department of Corporations (DoC) has acknowledged, "[W]hen payday loans are used for a long period of time, the fees charged can rapidly exceed the amount borrowed and can create a serious financial hardship for the borrower."[15] Adopting a loan limit would prevent borrowers from utilizing the payday loan as a long-term source of credit.[16] This reform would maintain the current cost of a payday loan, while ensuring its use is truly short term.

Give Families More Time to Repay a Payday Loan Without the Need to Borrow Again: Extend the Minimum Loan Term. The extremely short term of a payday loan is one of the key features that serves to trap borrowers in long term debt. Extending the term would reduce the cost of the loan and increase the repayment period,[17] making it more likely that a borrower will be able to accumulate the funds to pay off the loan without taking out another one.[18]

Ensure That Families Can Afford to Repay a Payday Loan: Require Robust Underwriting. Families fall into a cycle of repeat lending with payday loans because they cannot afford to repay the loan after two weeks and still meet their basic expenses. Requiring that payday lenders evaluate each borrower's ability to repay the loan, modeled on underwriting provisions of the small-dollar loan pilot program, may help borrowers repay their loans without the need to borrow again.[19]

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[1] Uriah King & Leslie Parrish, *Springing the Debt Trap: Rate Caps are Only Proven Payday Lending Reform* at 7-8 (Center for Responsible Lending Dec. 13, 2007), available at http://www.responsiblelending.org/payday-lending/research-analysis/springing-the-debt-trap.pdf.

[2] In addition to the data itself, industry pronouncements make this clear. For example, Dan Feehan, CEO of Cash America remarked at the 2007 Jefferies Financial Services Conference: "And the theory in the business is you've got to get that customer in, work to turn him into a repetitive customer, long-term customer, because that's really where the profitability is." *See id.* at 1. Others in the industry have a similar analysis: "The financial success of payday lenders depends on their ability to convert occasional users into chronic borrowers," "This industry could not survive if the goal was for the customer to be 'one and done'. Their survival is based on the ability to create the need to return, and the only way to do that is to take the choice of leaving away." *See id.* at 10-11. Similarly, the FDIC's Center for Financial Research undertook a study of the industry based on payday lenders' proprietary data, and found that the profitability of payday lending is driven by volume, and acknowledged that "… high-frequency borrowers account for a disproportionate share of a payday store's loans and profits. *See* Uriah King, et al., *Financial Quicksand: Payday Lending Sinks Borrowers in Debt with $4.2 Billion in Predatory Fees Every Year* at 8

(Center for Responsible Lending Nov. 30, 2006), available at http://www.responsiblelending.org/payday-lending/research-analysis/rr012-Financial_Quicksand-1106.pdf.

[3] Department of Corporations, *2011 Annual Report: Operation of Deferred Deposit Originators Licensed Under the California Deferred Deposit Transaction Law* at 4 (Oct. 31, 2012) (hereinafter "DoC Report"), available at http://www.corp.ca.gov/Laws/Payday_Lenders/pdfs/CDDTL2011ARC.pdf.

[4] *Id.*

[5] Leslie Parrish & Uriah King, *Phantom Demand: Short-Term Due Date Generates Needs for Repeat Payday Loans, Accounting for 76% of Total Volume* (Center for Responsible Lending July 9, 2009), available at http://www.responsiblelending.org/payday-lending/research-analysis/phantom-demand-final.pdf.

[6] *Id.*

[7] The number of loans in 2006 was 10,048,422. DoC Report at 6, Table 1-1. The total number of borrower families is 1.01 million. *See 2007 Department of Corporations Payday Loan* Study at ix (Applied Management & Planning Group Dec. 2007; Updated June 2008), available at http://www.corp.ca.gov/Laws/Payday_Lenders/Archives/pdfs/PDLStudy07.pdf.

[8] DoC Report at 13, Table 2-1. These estimates assume borrowers who took out 6-12 consecutive loans averaged 9 loans per spell, those who took out 13-18 consecutive loans averaged 16; and those with 19 or more consecutive loans averaged 21 loans per spell. These totals are then divided by 10.048 million, the total number of loans.

[9] *Id.*

[10] *Id.* This was calculated by assuming 387,338 loans were made to single loan borrowers, and dividing by 10.048 million, the total number of loans.

[11] Researchers from Vanderbilt and Oxford found that over half (54%) of all payday borrowers will default in the first twelve months based on an analysis with two million observations. Paige M. Skiba, & Jeremy Tobacman, *Payday Loans, Uncertainty, and Discounting: Explaining Patterns of Borrowing, Repayment, and Default* (Aug. 21, 2008), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1319751. CRL later found that 44 percent of borrowers will experience a "return event" or default in which borrowers cannot service their payday loan debt in a timely manner. Uriah King & Leslie Parrish, *Payday Loans, Inc. Short on Credit, Long on Debt* (Mar. 31, 2011), available at http://www.responsiblelending.org/payday-lending/research-analysis/payday-loan-inc.pdf.

[12] *See* Paige M. Skiba & Jeremy Tobacman, *Do Payday Loans Cause Bankruptcy?* (Nov. 9, 2009), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1266215.

[13] Using a database of Texas borrowers, the authors find that taking out a payday loan makes a borrower 92 percent more likely to become seriously delinquent (i.e., 90 days or more late) on their credit card during the year. *See* Sumit Agarwal, et al., *Payday Loans and Credit Cards: New Liquidity and Credit Scoring Puzzles?* (Jan. 13, 2009), available at http://www.nber.org/papers/w14659.

[14] The FDIC Guidelines provide that a borrower should be restricted from having payday loans outstanding from any payday lender for more than three months in any 12-month period. Federal Deposit Insurance Corporation, *Payday Lending Programs Revised Examination Guidance* (Mar. 1, 2005), available at http://www.fdic.gov/news/news/financial/2005/fil1405a.html.

[15] DoC Report at 44.

[16] *Id.*

[17] DoC Report at 45 (including extending the minimum payday loan term to 31 days as one of the policy options).

[18] In 2010, Colorado amended its payday statute to make the minimum loan term 6 months. *See* Colorado House Bill 10-1351 (Approved May 2010), available at http://www.state.co.us/gov_dir/leg_dir/olls/sl2010a/sl_267.htm. Additionally, in 2007 Congress restricted payday lending to the military, and among other things provided for a minimum 91 day term. See John Warner National Defense Authorization Act for Fiscal Year 2007 Section 987, available at http://www.govtrack.us/congress/bills/109/hr5122.

[19] (Cal. Finance Code § 22352(g)(3))